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Market Timing and Technical Analysis

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THE HISTORY AND EVOLUTION OF TECHNICAL SECURITY ANALYSIS

Over recent years, the use of technical analysis in the investment decision-making process has become more commonplace. Today's more sophisticated investor generally has some type of technical application at hand, whether it be a simple chart package, or a sophisticated computer program.

Yet, for some reason, there is still some misunderstanding about the technician's craft. Some critics still flaunt technical analysis as being akin to astrology, or worse.

As we are updating this contribution to the *Handbook,* the stock market as measured by the Dow Jones Industrial Average has just suffered its greatest one-day *point* drop in history, dropping 61.87 points. The financial press was abundant with reasons for the decline, but emphasis has been placed on the "cautious words" having recently been pronounced by a number of stock market technicians. This theory, in turn, resulted in a feature story on the first page of the second section of *The Wall Street Journal.* The headline: "Stock Market's Technical Analysts Get New Respect after Price Drop." While the article does afford a somewhat credible review of some of the negative technical factors that led some analysts to offer words of warning, we suppose to "balance" the story it was necessary to offer a few words of criticism regarding the technical approach. Reading the views of some well-known, but obviously straight-on-fundamentally oriented portfolio

managers, we had a feeling of déjà vu. Said one, "These analysts [technicians] might as well look at random numbers and try to predict the next one." Another manager noted, "In the long run, you could do as well with Ouiji boards or tarot cards." An academic input was interesting as well: "These people make a lot of predictions, and occasionally one of them will come right. But listening to them regularly can be hazardous to your wealth."

We sense that more thoughtful students are finally realizing that *all forms* of market analysis have their own particular shortcomings. Random walk is being debunked by the same theoreticians that first supported it. Modern portfolio theory (MPT) has lost many of its original followers. Fundamental earnings estimates are often far off target, and economic forecasts can often turn out to be ill founded, or vary greatly from one economist to another. All forms of analysis are really exercises in educated guess work. Technical methods are no different.

One reason we suspect the technical approach has had more than its share of critics is because there haven't been all that many textbooks available on the subject. Yet many authoritative works on the approach can be found with copyrights dating from the turn of the century, if not earlier. Books on fundamental analysis became greater in number *after* the passage of the Securities and Exchange Commission Acts of 1932, and 1933. To wit, the so-called bible of fundamental analysis, *Security Analysis*, by Graham and Dodd, was first in print as of 1934.

Our research indicates technical analysis is the *oldest* form of security analysis known to man. We believe charts were first used in Japan in the 17th century to plot the price of rice, possibly representing the earliest application of trend analysis disciplines. Technical analysis is a common investment tool in Japan today. The Japanese stock market is the second largest capitalized formal trading market in the world (after the NYSE), and many Japanese technicians use methods more specialized to their market's trends. In the United States, technical applications can be traced back over 100 years when financial statements were *not readily available* for any type of quantitative analysis. In the late 1800s and early 1900s, if a "researcher" visited the corporate offices of a major concern and asked, "How's the business?" he was no doubt politely told, "It is none of yours!"

Over the years we have learned to look at our role of a technician as being close in kind to that of a navigator. We think of our clients as the "pilots," entrusted with the decision-making role in guiding their personal or professional accounts. Technical studies of the market, group behavior, or stock trends can determine evidence of shifting demand/supply activity which can easily be likened to the navigator warning the pilot of a storm ahead. Like the navigator, the technician will not always be correct in his readings, or a change in "patterns"

could easily develop rendering the original interpretation invalid. But whatever the outcome, we sure wouldn't want to fly with a pilot that constantly ignores his navigator. Of course, a record of the navigator's "calls" should be maintained as well.

Success in the stock market comes by minimizing risk. But, unfortunately, many look at the market from the viewpoint of reward only, sometimes taking unnecessary risk to achieve it. Buying a stock with apparent strong fundamentals and little regard for the stock's technical position can easily result in a quick loss. Many stocks can "top-out" when, as the saying goes, "business couldn't be better." On the other hand, undue risk is also taken when making a commitment strictly on technical grounds. Many good-looking stocks have fallen out of so-called base formations due to an unexpected poor earnings report. Therefore it seems logical that a combination of both types of securities analysis should result in better decision making and the results that follow. Since technical analysis is primarily a timing tool, it could be said that fundamental analysis represents the "what" input, while technical analysis is the "when."

Cutting losses short is crucial for long-term investment success. We have often referred to a simple philosophy whereby we look at our decision making as an exercise that can result in only one of five eventual outcomes. We can experience an unchanged position, a large profit, large loss, small profit, or a small loss. If we can possibly eliminate one of these outcomes, obviously the large loss, then we are merely left with the other four. Over a number of years the small profits, losses and unchanged positions will "offset" each other. Therefore we are left with the enjoyment of occasionally booking the large profit. Many technical methods can be employed as long-term disciplines to guard against the large loss. We are sure that other analytical inputs can be loss-inhibiting procedures as well, but the author believes the technical approach seems to lend itself quite readily to such an application.

Technical analysis is applicable to all price trends that are founded upon a fairly efficient marketplace where buyers meet sellers in an auction process. As such, applications are not limited to only stocks and stock markets, domestic or international. Indeed, technical analysis can be profitably utilized for bonds, or fixed-income markets, groups or sectors within the stock market, foreign stock markets, currencies and obviously not to be overlooked, commodities. In fact, there are probably more technical methods around today for the growing futures derivatives than any other application. The growth of the personal computer has led to a proliferation of technical software for both stocks and commodities, with the latter really possessing an inordinate number of packages, many sophisticated, but a good number not worth a small fraction of their cost.